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SUBCHAPTER S CORPORATIONS

I. INTRODUCTION

Prior to September 2, 1958, the Internal Revenue Code taxed earned income of a business either as individual income or as corporate income, depending upon the type of ownership of the particular business.¹ In his return the individual taxpayer included net income derived as a sole proprietor or his share of such income if derived as a partner in a partnership. If the business was operated as a corporation, the corporation must have included in its corporate return all annual net income derived from the operation of the business. In the case of a corporation, such income was subject to a second tax if and when it was distributed to the individual stockholders. In the past there was no provision in the Code permitting stockholders to be taxed on corporation income on their individual tax returns. If a business, regardless of size, did incorporate wishing to avail itself of such factors as limited liability, continuity of existence, sick-pay plans, qualified pension and profit-sharing plans,² it subjected itself to a 52 per cent corporate rate (30 per cent rate in case of the smaller corporations) where the earnings are left in the business.³ It is obvious that where the stockholders are in a lower tax bracket, it would be advantageous to assess the income to them individually rather than to the corporate entity.

II. HISTORY

President Eisenhower in his 1954 Budget Message to the Eighty-Third Congress recommended that:

Small businesses should be able to operate under whatever form of organization is desirable for their

1. Int. Rev. Code of 1954, § 1, § 11.

2. Greenwald, *Tax Subchapter S Becomes Clearer*, 9 Clev.-Mar. L. Rev. 566, 571 (1960).

3. Plowden-Wardlaw, *Election of Certain Small Business Corporations as to Taxable Status*, 23 Albany L. Rev. 245, 246 (1959).

particular circumstances, without incurring unnecessary tax penalties. To secure this result, I recommend that corporations with a small number of active stockholders be given the option to be taxed as partnerships⁴

This recommendation was not enacted by the Eighty-Third Congress, but was finally approved by the Eighty-Fifth Congress in 1958.⁵

The purpose of the provisions was to permit small business ". . . to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences."⁶ Specifically, it was intended to aid small businesses by allowing an electing small business corporation's stockholders to pay individual income tax on their proportionate shares of the corporate income in lieu of the corporate tax, or in case of a corporation's operating loss, to offset their shares of the loss against their other income.⁷

III. ELIGIBILITY REQUIREMENTS

Subchapter S elections are limited to small business corporations as defined in section 1371 of the 1954 Internal Revenue Code. One prerequisite⁸ of an electing corporation is that it must have been created or organized in the United States or under the law of the United States or of a state or territory. These electing corporations may not have a non-resident stockholder.

An electing small business corporation must not be a member of an affiliated group of corporations. Such affiliation after election automatically terminates its "electing" status.⁹

Probably the greatest restriction on an electing corporation is that it must not have more than ten stockholders,

4. 1 U.S. Code Cong. & Adm. News, 83rd Cong., 2nd Sess., p. 1567 (1954).

5. 72 Stat. 1650 (1959), 26 U.S.C. § 1371 (1962).

6. S. Rep. No. 1983, 85th Cong., 2nd Sess. (1958).

7. Patty, **Qualification and Disqualification Under Subchapter S**, 18 N.Y.U. 18th Inst. on Fed. Tax., 661, 663 (1960).

8. This and other prerequisites to follow are found in Int. Rev. Code of 1954, § 1372.

9. Treas. Reg. § 1.1371-1 (1960).

and these stockholders must be either natural persons or estates. Each person who has an interest in the stock is considered a separate stockholder, except for husband and wife holding stock as co-tenants, joint tenants, tenants by the entirety, or as community property.¹⁰ The election is automatically terminated upon the death of the stockholder if the distribution of his shares to his heirs creates more than the maximum of ten stockholders. To prevent this, it is provided that the executor may elect within 30 days after he assumes his duties. This qualifies the corporation to continue its electing status, at least until there is further distribution of the stock.¹¹ Generally, any persons for whom stock is held by a nominee, agent, guardian, or custodian will be considered a shareholder of the corporation.¹² Since ownership is limited to natural persons and estates, the acquisition of a qualifying corporation's shares by another corporation, partnership, or a trust disqualifies the corporation.

The corporation's outstanding stock must be of one class. The shares must be ". . . identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation, . . ." ¹³ If the certificates of ownership evidence different voting or profit rights, more than one class will be outstanding and the association cannot qualify under Subchapter S. Caution should be taken with regard to debt obligations in order that they don't take on characteristics of a second class of stock.¹⁴

Although the Subchapter S election is limited to small business corporations, there is no value restriction placed on such corporations. However, as a practical matter, due to the size and type of the operations, and the complex capital structure involved, large associations will not qualify.¹⁵

An electing corporation must have the written consent of all the shareholders on the first day of the taxable year

10. Treas. Reg. § 1.1371-1(d) (1960).

11. Treas. Reg. § 1.1372-3(b) (1960), as amended, T.D. 6615 (1962).

12. Treas. Reg. § 1.1371-1(d) (1960).

13. Treas. Reg. § 1.1371-1(g) (1960).

14. *Ibid.*

15. Greenwald, *supra* note 2, at 570.

for which the election is effective.¹⁶ If a person should become a shareholder during the election year, he must file a written statement of his consent within 30 days after his acquisition of the stock. Failure to comply automatically terminates the corporation's election status.¹⁷

It has been recommended that a new stockholder's consent be presumed unless he files an express dissent.¹⁸ This would protect the corporation from an unwanted termination in the event that such stockholders forget to file within 30 days. The consent of a minor stockholder may be given by the minor himself or his legal or natural guardian.¹⁹

IV. EFFECT OF ELECTION

Stockholders of a Subchapter S corporation are taxed on the corporation's net income as though it had been earned entirely by them. Income in the form of cash dividends distributed during the year is taxable to the stockholders at the time of distribution. The net income which has not been distributed, is taxed *pro rata* to the stockholders as though it had been distributed as a dividend on the last day of the corporation's taxable year.²⁰ The stockholders get no dividend exclusions, credits, or retirement income credit for the actual distributions made out of current earnings and profits.²¹

An excess of net long-term capital gain over any net short-term capital loss is included in the income of the stockholders as a long-term capital gain, but this amount cannot be greater than the net income of the corporation.²² However, where net short-term capital gain of the corporation exceeds net long-term capital loss, the net short-term gain loses its character as capital gain and is taxable to

16. Int. Rev. Code of 1954, § 1372(a).

17. See *supra* note 11.

18. Lourie, *Subchapter S After Three Years of Operation*, 18 Tax L. Rev. 99, 107 (1962).

19. Treas. Reg., *supra* note 13, at (a).

20. Valentine, *Taxation of Shareholders of Subchapter S Corporations During the Election Period*, 18 N.Y.U. 18th Inst. on Fed. Tax., 689, 690 (1960).

21. 1 P-H 1963 Fed. Tax Serv. ¶ 4786.

22. Treas. Reg. § 1.1375-1(a) (1960).

the stockholders as ordinary income.²³

Serious problems can arise where the stockholder and the corporation have conflicting taxable years. The difficulties being in ascertaining the proportion of the distribution which is ordinary income and that which is capital gain when the corporate year ends long after the taxable year of the stockholder. A suggested solution would be to allow a shareholder an extension of time within which to file his tax return to permit determination of the character of the income; or as also suggested, the stockholder could file a timely return and later amend the return after the close of the corporation's year when the required information becomes available.²⁴

The undistributed taxable income is allocated only to those who were stockholders on the last day of the corporation's taxable year, even though they may not have been stockholders for the entire year. If a stockholder sells his shares before the close of such taxable year, none of the undistributed income is taxable to him. This seems to be an inequity since a stockholder acquiring stock near the close of the taxable year would not have shared in the year's distributed profits, but would be taxed on those not distributed.

If the undistributed income is distributed in a subsequent year, such stockholders who originally paid income tax on the undistributed income in a prior year may now take it tax-free if there has been no break in the Subchapter S election.²⁵ It might be noted that this right to receive tax-free dividends is personal to the stockholder who actually reported the undistributed taxable income in a prior year. Another factor in this tax-free distribution provision, is that while an election is in effect, cash distributions to stockholders are deemed to have been made first from current earnings and profits, secondly, from undistributed taxable income, and finally from accumulated earnings and profits. Therefore all current earnings and profits must have been distributed

23. Valentine, *supra* note 20.

24. Goodson, Scheifly, Thompson, *Planning with Subchapter S in 1960*, U. So. Cal. 1960 Tax Inst., 165, 188.

25. Int. Rev. Code of 1954, § 1375(d).

before any undistributed taxable income can be withdrawn.²⁶

The tax-free distribution will reduce the stockholder's stock basis, and if the distribution exceeds his basis, the excess will be considered gain from a sale or exchange. This, in effect, will result in a double tax where a stockholder sells his stock during the year on that portion of the earnings accumulated prior to the sale. A capital gains tax upon the portions of the sales price represented by the earnings accumulated up to that time will be due from the stockholder. The buyer then must include in his income tax return the portion of the earnings accumulated prior to his acquisition of the stock either when received as a dividend or as undistributed taxable income.²⁷

If the electing corporation has a net operating loss, a stockholder can treat his share of such loss as one incurred in his own trade or business and deduct it from his gross income, or carry it back or over.²⁸ Such net operating loss is pro-rated among the shareholders based on the number of days in the corporation's taxable year during which the shareholder held the stock.²⁹ Under the law as it was originally enacted, a stockholder, who died before the end of the corporation's taxable year, was deprived of his share of the net operating loss which occurred in the corporation's taxable year in which he died. Subsequent amendments gave the decedent the same rights in regard to sharing in such loss as a selling stockholder.³⁰

The net operating loss of the Subchapter S corporation which is passed through to the stockholder cannot exceed the sum of the stockholder's basis for his stock and his basis for indebtedness which the corporation owes him. In view of this limitation, a stockholder may desire to make a loan to the corporation and take a net operating loss on his own return for the amount loaned the corporation.³¹

Excessive compensation paid to stockholders has given rise to problems in Subchapter S corporations. It would

26. Goodson, Schelfly, Thompson, *supra* note 24, at 183.

27. Valentine, *supra* note 20, at 691.

28. Int. Rev. Code of 1954, § 1374.

29. Treas. Reg. § 1.1374-1(a)(3) (1960).

30. Int. Rev. Code of 1954, § 1374(b), as amended by Pub. L. No. 376 (1959, and § 30 of the Rev. Act of 1962.

31. Int. Rev. Code of 1954, § 1376.

seem that payments of excessive compensation should normally be taxed as dividends. In such case the tax result would be the same as though allowed as a deduction, but it may effect the deductions for contributions to qualified pension or profit sharing plans or the corporate deduction for charitable contributions. If the excessive compensation were treated as a cash dividend, the undistributed income of the corporation would be increased. In that event all stockholders would pay a tax on money paid to one stockholder as compensation. Further, the excessive compensation would probably be taxed to the employee also, thus resulting in a double tax on the excessive compensation.³²

To prevent the avoidance of Federal income tax by the device of dividing up the stock of a Subchapter S corporation among the real owner's family, the Secretary of the Treasury has the power to allocate the income between the various family members in order to reflect the value of services rendered.³³

V. TERMINATION OF ELECTION

Once a corporation elects to file as a Subchapter S corporation, such election is effective for the taxable year it is made and for all succeeding taxable years unless terminated.³⁴ Termination can be brought about in various ways:

... from the formal revocation of the election, from the failure of the corporation to continue to meet the statutory requirements as to its capital stock and the ownership of such stock, or from certain developments with respect to the income of the corporation from foreign sources or from types of income generally described as personal holding company income.³⁵

The election may be formally terminated for any year subsequent to the first taxable year as a Subchapter S corporation, provided all shareholders consent to such termination, and file a statement of revocation with the District

32. Valentine, *supra* note 20, at 696.

33. Int. Rev. Code of 1954, § 1375(c).

34. Int. Rev. Code of 1954, § 1372(d).

35. Stinson, **Terminating the Election under Subchapter S**, 18 N.Y.U. 18th Inst. on Fed. Tax., 707 (1960).

Director of Internal Revenue. The revocation is applicable to the taxable year in which made only if made during the first month of that year. If made after the first month, the revocation applies only to the next succeeding taxable year. The termination is effective for the year it ceases to qualify and for all subsequent years.³⁶

If any of the prerequisites of an electing small business corporation herein discussed are breached any time after election the election automatically terminates. If the corporation acquires a new stockholder who does not file his consent within 30 days, the election is automatically terminated.³⁷ If the corporation derives more than 80 per cent of its gross receipts from sources outside the United States termination results.³⁸

If more than 20 per cent of the gross receipts of the corporation consist of royalties, rents, dividends, interest, annuities or receipts from sales or exchanges of stock or securities, for any taxable year, the election is terminated.³⁹ Gross receipts as here applied means the total amount acquired under the methods of accounting used by the corporation in computing its taxable income. Royalties include mineral, oil, and gas royalties, whether or not they constitute personal holding company income. Also receipts for use of patents, copyrights, secret processes and formulae, good will, trade marks, trade brands, franchises, and other like property are included. Rents include the amounts received for use of, or right to use the real or personal property of the corporation, whether or not such amounts constitute personal holding company income. However, this does not include payments for rooms or occupancy space where significant services are rendered to the occupant. Services as applied here constitute those rendered to the occupant primarily for his convenience and in excess of those normally rendered in connection with rentals. Dividends include all dividends which qualify with respect to corporate distribution. Interest means any amount received for the use of

36. Int. Rev. Code of 1954, § 1372(e)(2).

37. Int. Rev. Code of 1954, § 1372(a).

38. Int. Rev. Code of 1954, § 1372(e)(4).

39. Int. Rev. Code of 1954, § 1372(e)(5).

money. Annuities include the entire amount received under an annuity, endowment, or life insurance contract.⁴⁰

When determining whether or not a Subchapter S corporation is disqualified because of receiving more than 20 per cent of its gross receipts from sales or exchanges or stock or securities, such sales or exchanges are taken into account only to the extent of gains therefrom. Therefore the gross receipts from the sale of particular shares of stock will be the excess of the amount realized over the adjusted basis of such share.⁴¹

If a Subchapter S election is terminated because of a disqualifying event, the termination is retroactive for the taxable year in which the disqualifying event occurs, and for all succeeding taxable years.⁴² Once a valid election has been terminated or revoked, the corporation, or any successor corporation, may not make another like election for five years after the terminating year, unless the Secretary or his delegate consents to the re-election.⁴³

It seems that a strict interpretation of these disqualifying provisions, e.g., an eleventh stockholder, would make it possible for a deliberate termination of the electing status of the corporation at any time, regardless of the requirements of the formal revocation provision. Despite this inconsistency, no other interpretation of the law or subsequent regulations have been fostered.

VI. CONCLUSION

This has not been an attempt to speculate as to the advantages or disadvantages of electing under Subchapter S. There has been much written on the pros and cons of making such an election.⁴⁴ Whether a corporation would profit from making the election depends upon many factors and

40. See generally, Treas. Reg. § 1.1372-4(5) (1960).

41. Treas. Reg. § 1.1372-4(5)(viii) (1960).

42. Patty, *Qualification and Disqualification Under Subchapter S*, 18 N.Y.U. 18th Inst. on Fed. Tax., 661, 682 (1960).

43. Int. Rev. Code of 1954, § 1372(f).

44. Cunningham, *Subchapter S Corporations: Uses, Abuses, and Some Pitfalls*, 20 Md. L. Rev., 195 (1960); Hoffman, *Let's Go Slow with Tax Option Corporations*, 37 Taxes 21 (1959); Horwich, *The Small Business Corporation*, 37 Taxes 20 (1959); Landis, *Advantages and Disadvantages of the Subchapter S Election*, 18 N.Y.U. 18th Inst. on Fed. Tax., 723 (1960).

circumstances of the particular corporation. Tax brackets of the stockholders, financial condition of the corporation, future plans and prospects of the corporation, are all factors that will help determine the suitability of a Subchapter S election. State tax consequences should also be considered.

Some states, like New York, have statutes providing that net income for tax purposes shall be "...presumably the same as the entire income which the taxpayer is required to report to the United States Treasury Department, ..."⁴⁵ The New York State Tax Commissioner has ruled that the income would be computed in the same manner as if the corporation were required to file a regular Federal income tax return.⁴⁶

Other states having statutes like North Dakota permit a deduction of federal income taxes in computing income for state tax purposes.⁴⁷ Whether the stockholders of an electing corporation will be entitled to any such *pro rata* deduction is an interesting problem which as yet remains unanswered. It would seem fair to allow such a deduction to the shareholders. Such state tax ramifications would be another factor to be considered by corporations contemplating making an election under Subchapter S.

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45. N.Y. Tax Law § 208-9 (McKinney 1954)

46. Valentine, *Taxation of Shareholders of Subchapter S Corporations During the Election Period*, 18 N.Y.U. 18th Inst. on Fed Tax., 689, 704 (1960).

47. N.D. Cent. Code § 57-38-22(3) (1961).